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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 279

INGLE COAL CORPORATION, PETITIONER

v.

THE UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. App. 1a-11a) is reported at 127 F. Supp. 573.

JURISDICTION

The judgment of the Court of Claims was entered on January 11, 1955. (Pet. App. 1a; R. 81.) A motion for rehearing filed by the taxpayer was denied on May 3, 1955. (R. 105.) The petition for a writ of certiorari was filed on July 29, 1955. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1255.

QUESTION PRESENTED

Taxpayer's predecessor, a family corporation, mined coal lands under a lease which obligated it

to pay a stipulated royalty to the lessor. The stockholders caused its assets and liabilities to be transferred to themselves in liquidation, and contemporaneously retransferred them to a newly formed corporation (taxpayer), which continued to carry on the business of the predecessor and in which their stock interests were the same. As part of the arrangement taxpayer agreed to pay the stockholders a "royalty" in addition to that paid the lessor. Did the Court of Claims err in holding that the additional royalty payments did not constitute ordinary and necessary business expenses deductible from taxpayer's gross income under Section 23(a)(1)(A) of the Internal Revenue Code of 1939?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23 [As amended by Sec. 121(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount ex-

> pended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> (26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> Sec. 29.23(a)-1. *Business Expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business * * *.

STATEMENT

The facts as stipulated and found by the Court of Claims (Pet. App. 11a-29a) may be summarized as follows:

The Ingle Coal Company, taxpayer's predecessor, was engaged in the business of mining coal on lands held under a lease which obligated it to pay the lessor (Wasson) a royalty of five cents per ton of coal mined. On June 30, 1942, it had 2,000 shares of stock outstanding, all of which were owned by members of the Ingle family—two brothers, two sisters, and the children of the brothers. The brothers were the officers of the company, and

they and their sisters constituted four of the five directors. (Pet. App. 11a-13a, 23a.)

In the spring of 1942 Ingle Coal Company received an offer of $1,000,000 for its assets. This offer was rejected, one of the reasons being the substantial amount of income tax liability which the company and its stockholders would incur if the properties were sold. (Pet. App. 13a.) Instead, the stockholders adopted a plan to form a new corporation which would take over the assets and liabilities of the existing one. On June 30, 1942, they held a stockholders' meeting at which it was resolved that the corporation liquidate and distribute its property to them or their nominees, and they directed the officers to transfer the property to the newly organized taxpayer corporation (Ingle Coal Corporation) as their nominee. (Pet. App. 14a-16a.) Immediately thereafter the stockholders of the old company met as organizers and directors of the new. At this meeting they received from themselves on behalf of taxpayer a proposal to convey all the assets of the old company in consideration of the issuance of taxpayer's stock to them in proportion to their stock holdings in the old company, the assumption by taxpayer of all the liabilities of the old company (including the obligation to pay royalties under the existing Wasson lease), and, in addition, an agreement by taxpayer to pay them in proportion to their stock holdings an additional royalty of five cents per ton on all coal produced. This proposal was contemporaneously accepted on behalf of taxpayer, and documents evidencing the

arrangement were executed by the old company, the new company, and the stockholders. (Pet. App. 16a-21a.)

The plan was adopted and consummated for the purpose of reducing taxes, assuring a more definite income to the sister stockholders, and permitting them to retain an interest in the business (the over-riding "royalty" contract) despite a transfer of the stock. (Pet. App. 29a.)

After consummation of the plan taxpayer continued to carry on the business of the predecessor, paid the lessor of the property the agreed royalty which the predecessor had contracted to pay, and in addition paid to its stockholders the over-riding "royalty" which it had contracted to pay them under the plan. In 1943 one of the two sister stockholders died; her stock was sold in equal portions to the brother stockholders and their children, and her rights in the overriding royalty contract were distributed to her heirs. In 1944 the other sister donated some of her stock, and in 1946 sold the remainder, to the children of the brothers. As a result of these transfers the entire stock of taxpayer was held in equal one-half shares by the two brothers and their respective families. The heirs of the deceased sister, and the living sister, retained their interest in the overriding royalty contract. (Pet. App. 24a-25a.)

Taxpayer had substantial net earnings in each of the years 1942 to 1948. Its accumulated earnings amounted to $185,596 at the end of 1947 (after charging to surplus $750,000 paid for a new mine),

and $675,195 at the end of 1948. In addition to the over-riding royalty payments to the stockholders, it paid dividends in each of the years 1944 to 1948. (Pet. App. 27a-28a.)

In its income tax returns for 1942 and 1943, taxpayer deducted from its gross income, in addition to the royalty paid to the lessor, the amounts paid to its stockholders as over-riding royalties. The Commissioner allowed as deductions the payments to the lessor, but disallowed those made to the stockholders. The Tax Court sustained the Commisioner's determination (10 T.C. 1199) and the Court of Appeals for the Seventh Circuit affirmed (174 F. 2d 569). (Pet. App. 2a-3a, 26a-27a.)

In its income tax returns for 1947 and 1948 (the taxable years here involved), taxpayer deducted from its gross income, in addition to the royalties paid the lessor, the royalties paid the brother stockholders, the living sister, and the heirs of the deceased sister. These amounted to $42,761 for 1947, and $34,223 for 1948. The Commissioner again disallowed the over-riding royalty payments, and the resulting deficiency in tax was paid. A timely refund claim was filed by taxpayer, and after the expiration of six months the present action was instituted. (Pet. App. 25a-28a.)

The Court of Claims held that the prior final decision of the Seventh Circuit Court of Appeals (174 F. 2d 569), involving the years 1942 and 1943, did not operate to estop taxpayer from litigating its present claim for the years 1947 and 1948. On the merits, it held that the so-called over-riding

royalty payments were not ordinary and necessary business expenses of the taxpayer corporation deductible under Section 23(a)(1)(A) of the Internal Revenue Code of 1939, but in substance constituted non-deductible dividend distributions. (Pet. App. 1a-9a.) Two judges dissented. (Pet. App. 9a-11a.)

ARGUMENT

The decision below, applying settled principles to the particular facts of this case, is correct. There is no conflict and no occasion for further review.

1. Section 23(a)(1)(A) of the Internal Revenue Code of 1939, *supra*, pp. 2-3, authorizes a deduction from gross income of "ordinary and necessary" business expenses. Section 115(a) defines a dividend as any distribution by a corporation to its shareholders out of accumulated or current earnings. That a payment is labeled an "expense" or is contractually incurred does not render it deductible; the "origin and nature" of the liability to pay, not its legal form, determine the right to the deduction. *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 594; *Deputy* v. *duPont*, 308 U.S. 488, 494-496; *Botany Mills* v. *United States*, 278 U.S. 282, 292. This rule is but a corollary of the fundamental principle that taxation is concerned with economic realities rather than legal formalities.[1] And where, as here, the payments

[1] *Commissioner* v. *Court Holding Co.*, 324 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Gregory* v. *Helvering*, 293 U. S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U. S. 609; *Bazley* v. *Commissioner*, 331 U. S. 737.

are by a family corporation to its controlling stockholders, the transaction is subject to special scrutiny lest what is essentially a non-deductible dividend distribution be disguised as a deductible expense. In harmony with these principles the Courts of Appeals in a long line of decisions have held that payments by a corporation to some or all of its stockholders may in reality constitute dividend distributions notwithstanding that they are made pursuant to a contract and are treated as expenses on the corporate books. See, *e.g.*, *Stanwick's, Inc.* v. *Commissioner,* 190 F. 2d 84 (C.A. 4th); *W. H. Armston Co.* v. *Commissioner,* 188 F. 2d 531 (C.A. 5th); *Ingle Coal Corp.* v. *Commissioner,* 174 F. 2d 569 (C.A. 7th); *Limericks, Inc.* v. *Commissioner,* 165 F. 2d 483 (C.A. 5th); *Paramount-Richards Th.* v. *Commissioner,* 153 F. 2d 602, 604 (C.A. 5th); *Regensburg* v. *Commissioner,* 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783; *Illinois Agricultural Hold. Co.* v. *Commissioner,* 131 F. 2d 583 (C.A. 7th); *Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C.A. 2d), certiorari denied, 311 U.S. 680.

As is plain from its opinion, the court below applied the controlling principles to the undisputed facts of this case. Taxpayer's predecessor was the lessee of coal mines under a long-term lease which obligated it to pay the lessor a stipulated royalty. Its stockholders, directors, and officers consisted of closely related members of the Ingle family. At the end of June, 1942, pursuant to a preconceived plan, the stockholders resolved to liquidate the

corporation, took legal title to its assets, and contemporaneously retransferred the assets to a newly formed corporation (taxpayer), which assumed the liabilities of the predecessor corporation and issued its stock to them in the same proportions as their former stock holdings. As an integral part of the plan, the stockholders caused taxpayer corporation to contract to pay them in proportion to their stock holdings a "royalty," in addition to the royalty payable to the lessor. Upon consummation of the plan taxpayer had the same assets and liabilities as its predecessor, except for the added obligation to pay an over-riding royalty to the stockholders. The net effect of the entire transaction was to substitute one wholly-owned corporation for another and, in the process, saddle the successor corporation with an additional "expense" payable to the stockholders. The liquidation distribution of the predecessor's assets did not give the stockholders real and independent ownership of the assets. It was merely an intermediate and transitory step in a corporate reorganization, the stockholders acting as conduits of the assets from the old corporation to the new. See Section 112(g)(1)(D) of the Internal Revenue Code of 1939; *Helvering* v. *Limestone Co.*, 315 U.S. 179, 184-185; *Survaunt* v. *Commissioner*, 162 F. 2d 753, 756-759 (C.A. 8th); *Heller* v. *Commissioner*, 147 F. 2d 376 (C.A. 9th), certiorari denied, 325 U.S. 868; *Commissioner* v. *Ashland Oil & R. Co.*, 99 F. 2d 588, 591 (C.A. 6th), certiorari denied, 306 U.S. 661; cf. *Minnesota Tea Co.* v. *Helvering*, 302

U.S. 609; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Bazley* v. *Commissioner*, 331 U.S. 737.

Had the additional "royalty" payments to the stockholders been made by the predecessor corporation itself, they undoubtedly would have represented dividend distributions, not deductible business expenses, for the corporation already had the right to use its property without paying any more for that use than the royalty it had previously contracted to pay to the lessor of the property. The same would have been true had the predecessor corporation directly transferred its property to the successor corporation, without the formal intervening liquidation distribution to the stockholders. That ownership of the property was circuitously routed from the predecessor to the successor corporation through the stockholders, who momentarily acquired bare legal title, cannot produce a different tax result. To hold otherwise would exalt artifice above reality. *Commissioner* v. *Court Holding Co., supra; Minnesota Tea Co.* v. *Helvering, supra; Gregory* v. *Helvering*, 293 U.S. 465; *Bazley* v. *Commissioner, supra.*[2] On the record here presented the court below was fully justified in concluding (Pet. App. 8a-9a) that the indirect trans-

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[2] In the words of this Court in the *Minnesota Tea Co.* case, *supra*, pp. 613-614—

> A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident * * *. The relation of the stockholders to the matter was that of a mere conduit.

fer had no genuine business purpose, but was a "device designed to convert nondeductible dividends into deductible royalty payments;" that the over-riding royalty payments to the stockholders should be "treated the same as if the plaintiff's predecessor corporation" had agreed to make the payments; and that the agreement "lacked real consideration, was gratuitous, and was in reality an arrangement for a distribution of dividends or profits in the guise of royalty payments."

True, in 1943 and 1944 the shares of the two sister stockholders (who together owned fifty percent of the stock) were transferred in equal portions to the two brother stockholders and their children, with the result that thereafter fifty percent of the additional royalty payments went to members of the family group who were no longer stockholders. (Pet. App. 24a.) But these transfers obviously did not serve to convert the other fifty percent of the payments, made to the brothers and their children, who remained stockholders, from dividend distributions into deductible business expenses.[3] And for the reasons pointed out by the court below (Pet. App. 9a), they did not serve to bring the fifty percent of the payments made to

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[3] It is settled that distributions of corporate earnings to stockholders may constitute dividends notwithstanding that they are not in proportion to stock holdings and that some of the stockholders do not participate in the distribution. *Regensburg* v. *Commissioner, supra; Paramount-Richards Th.* v. *Commissioner, supra.* Taxpayer admittedly had accumulated earnings during the taxable years in excess of the royalty payments in question. (Pet. App. 25a-26a, 28a.)

the non-stockholder members of the family within the ambit of deductible business expenses. In short, the question here is essentially no different from that presented in *Ingle Coal Corp.* v. *Commissioner,* 10 T.C. 1199, affirmed, 174 F. 2d 569 (C.A. 7th), involving the very same transaction and the taxable years 1942 and 1943. The decision below is in full accord with the decisions of the Tax Court and the Court of Appeals in that case.

2. Even assuming *arguendo* that the court below was obliged to view the payments in question as business expenses, rather than as dividend distributions, the payments still would not qualify for deduction as "ordinary and necessary" expenses within the meaning of Section 23(a)(1)(A). "To be deductible as business expenses, payments made must be both ordinary *and* necessary." *Illinois Agricultural Hold. Co.* v. *Commissioner, supra,* p. 585. See also *Welch* v. *Helvering,* 290 U.S. 111. And the "mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under Section 23(a)." *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 594. Furthermore, the claimed deduction must be examined in the light of the "now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines* v. *Commissioner, supra,* p. 593. See also *Deputy* v. *duPont,* 308 U.S. 488; *Welch* v. *Helvering, supra.* This burden has not been met by taxpayer.

The additional royalty expense in question was not "necessary," since taxpayer's predecessor already had the right to mine coal on its property in consideration of the stipulated royalty payments to the lessor, and all of its assets and liabilities were transferred to taxpayer. The imposition upon taxpayer of the obligation to make additional royalty payments cannot be considered "necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful" (*Welch* v. *Helvering, supra,* p. 113); its assumption of that additional liability was purely gratuitous (*Thomas Flexible Coupling Co.* v. *Commissioner,* 158 F. 2d 828 (C.A. 3d), certiorari denied, 329 U.S. 810; *Friedman* v. *Delaney,* 171 F. 2d 269 (C.A. 1st), certiorari denied, 336 U.S. 936; *Illinois Agricultural Hold. Co.* v. *Commissioner, supra; Ingle Coal Corp.* v. *Commissioner, supra*). Nor can the payments be considered "ordinary" expenses in the requisite sense that they were "of common or frequent occurrence in the type of business involved" (*Deputy* v. *duPont, supra,* p. 495); nothing in the record even remotely suggests that the over-riding royalty expense which taxpayer undertook in favor of its stockholders was usual in taxpayer's type of business, or, for that matter, in any other type of business. *A. Giurlani & Bro.* v. *Commisisoner,* 119 F. 2d 852 (C.A. 9th); *Paramount-Richards Th.* v. *Commissioner, supra; Illinois Agricultural Hold. Co.* v. *Commissioner, supra; Ingle Coal Corp.* v. *Commissioner, supra.* See also *White* v. *Fitzpatrick,* 193 F. 2d 398 (C.A. 2d), certiorari denied, 343 U.S. 928.

3. Taxpayer is mistaken in its assumption (Pet. 8-9, 12) that the holding of the court rests upon a disregard of the existence of the taxpayer's corporate identity. The court below fully recognized the reality and permanency of the taxpayer corporation. However, it correctly refused to view the transitory liquidation distribution of the predecessor's assets to the stockholders, and the stockholders' simultaneous retransfer of the assets to the newly created taxpayer corporation, as separate and independent transactions for tax purposes; it properly treated the two transfers as component steps in a single integrated transaction. The doctrine that tax consequences flow from the business substance rather than the legal form of a transaction applies with full force in the case of a planned "step transaction," one of whose steps is a liquidation distribution of corporate assets to the stockholders. *Helvering* v. *Limestone Co.*, 315 U.S. 179, 184-185; *Commissioner* v. *Court Holding Co., supra; Survaunt* v. *Commissioner, supra; Lewis* v. *Commissioner,* 176 F. 2d 646 (C.A. 1st); *Fairfield S. S. Corp.* v. *Commissioner,* 157 F. 2d 321 (C.A. 2d), certiorari denied, 329 U.S. 774. See Paul, "Step Transactions," *Selected Studies on Federal Taxation* (Second Series), pp. 200-254. The basic fallacy in taxpayer's argument is that it treats a reorganization transfer of property from one corporation to another as if it were a sale or lease by the stockholders to a third party, merely because one of the procedural steps in the reorgani-

zation plan was a liquidation distribution to the stockholders.[4]

4. Taxpayer asserts (Pet. 6-9) conflict with *John Kelley Co.* v. *Commissioner,* and *Talbot Mills* v. *Commissioner,* 326 U.S. 521. However, those companion cases involved the quite different question of whether so-called interest payments by a corporation constituted deductible "interest * * * on indebtedness" within the meaning of Section 23(b), and the answer turned upon whether the instruments under which the payments were made (debentures in *Kelley,* notes in *Talbot*) in substance represented a creditor or a proprietary interest in the corporation. The Tax Court reached opposite conclusions in the two cases, although they presented essentially similar situations, and this Court held that its decision in each case was nevertheless entitled to affirmance since the question was one within the province of the fact-finding tribunal.[5]

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[4] As this Court stated in the *Limestone* case, *supra,* pp. 184-185—

> the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these [reorganization] sections of the revenue acts where they add nothing of substance to the completed affair. * * * Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan.

[5] While this Court applied the "Dobson rule" (*Dobson* v. *Commissioner,* 320 U. S. 489) governing the scope of appellate review of Tax Court decisions, and that rule has since been supplanted by the "clearly erroneous" rule, the *Kelley* and *Talbot* cases still stand for the proposition that the question is one of ultimate fact for the trial court, whose decision should

Those cases are not controlling, or even relevant, as to whether a particular payment constitutes an ordinary and necessary business expense within the purview of Section 23(a)—the problem here presented.[6] And even if they be regarded as apposite, they surely cannot afford taxpayer any comfort, for they demand affirmance rather than reversal of the trial court's decision in this case. See also *Commissioner* v. *Court Holding Co., supra; United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451.

Equally unfounded is taxpayer's contention (Pet. 6, 9-15) that the court below misapplied the decision in *Gregory* v. *Helvering*, 293 U.S. 465, and related cases. To begin with, the contention proceeds on taxpayer's mistaken notion (Pet. 8-9, 12) that the court below challenged the permanency of the taxpayer corporation. As already noted the Court of Claims recognized taxpayer's permanent existence, but properly refused to consider the fleeting ownership of the assets by the stockholders as anything more than an intermediate procedural step in the reorganization transfer of the predecessor's assets to the taxpayer. In any event, far from having erred in relying on *Gregory* and similar cases, as taxpayer charges, the court below correctly applied the fundamental principle there enunciated, *i.e.*, that tax liability depends

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not be disturbed if supported by substantial evidence. See *1432 Broadway Corp.* v. *Commissioner*, 160 F. 2d 885 (C.A. 2d); *Janeway* v. *Commissioner*, 147 F. 2d 602 (C.A. 2d).

[6] Even the dissenting opinion below makes no mention of the *Kelley* and *Talbot* cases.

upon the substance of a transaction viewed from beginning to end, not upon its formal component steps. While the principle was applied in *Gregory* to deny recognition of an ephemeral corporation, it has been applied by this Court and the Courts of Appeals in a variety of other contexts.[7] Indeed, the *Gregory* doctrine has many times been applied in denying tax recognition to a transitory liquidation distribution by a corporation to its stockholders—the very type of case in which taxpayer here urges it is inapplicable. *Commissioner* v. *Court Holding Co., supra; Commissioner* v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570 (C.A. 2d), certiorari denied, 338 U.S. 955; *Fairfield S. S. Corp.* v. *Commissioner, supra; Meurer Steel Barrel Co.* v. *Commissioner*, 144 F. 2d 282 (C.A. 3d), certiorari denied, 324 U.S. 860; *Wichita Term. El. Co.* v. *Commissioner*, 162 F. 2d 513 (C.A. 10th); *Kaufmann* v. *Comissioner*, 175 F. 2d 28 (C.A. 3d).

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[7] See *e.g., Higgins* v. *Smith, supra; Griffiths* v. *Commissioner*, 308 U. S. 355; *Commissioner* v. *Court Holding Co., supra; Bazley* v. *Commissioner, supra; Commissioner* v. *Tower*, 327 U. S. 280; *Commissioner* v. *Transport Trad. & Term. Corp.*, 176 F. 2d 570 (C.A. 2d), certiorari denied, 338 U. S. 955; *Fairfield S. S. Corp.* v. *Commissioner, supra; Limericks, Inc.* v. *Commissioner, supra; Ingle Coal Corp.* v. *Commissioner, supra; United States* v. *Lynch*, 192 F. 2d 718 (C.A. 9th), certiorari denied, 343 U. S. 934.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1955.

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